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In the Supreme Court of the United States

OCTOBER TERM, 1979

INVESTORS RESEARCH CORPORATION, ET AL., PETITIONERS

v.

SECURITIES AND EXCHANGE COMMISSION, ET AL.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION IN OPPOSITION

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QUESTIONS PRESENTED

1. Whether, in an administrative proceeding before the Securities and Exchange Commission, the Commission must prove violations of Section 17(e)(1) of the Investment Company Act of 1940 by clear and convincing evidence, rather than by a preponderance of the evidence.

2. Whether, after a substantial conflict of interest by petitioners had been proven, the Commission properly shifted to petitioners the burden of coming forward with evidence showing that they had not received compensation prohibited by Section 17(e)(1).

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. A1-A22), as modified (Pet. App. A23-A25), is not yet reported. The opinion of the Securities and Exchange Commission (Pet. App. A27-A42) is reported at 14 S.E.C. Docket 1020.[1]

JURISDICTION

The judgment of the court of appeals was entered on April 29, 1980. An order amending the judgment was entered on June 11, 1980. The petition for a writ of certiorari was filed on July 28, 1980. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

Petitioner Investors Research Corporation ("Research") is an investment adviser registered with the Commission under the Investment Advisers Act of 1940. Petitioner James E. Stowers is the president and controlling stockholder of Research. During the period of time relevant to this proceeding, petitioners managed the investment portfolio of Twentieth Century Investors, Inc. (the "Fund"), a mutual fund registered with the Commission under the Investment Company Act of 1940.

Following an administrative hearing, the Commission found, by a preponderance of the evidence (see Pet. App. A42 n.30), that petitioners had willfully violated Section 17(e)(1) of the Investment Company Act, 15 U.S.C. 80a-17(e)(1), by receiving compensation from two brokerage firms in return for directing virtually all of the Fund's brokerage business to those firms between August 1973

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[1]The Commission's opinion, as printed in the appendix to the petition, includes headnotes written by Commerce Clearing House, Inc., that are not part of the opinion.

and December 1974 (Pet. App. A30-A33). The justification offered by petitioners for receiving the money was that they had provided certain computer services to the brokerage firms. One of the firms, Mullaney, Wells and Company ("Mullaney"), agreed to pay Research $15,000 down and $6,000 per month, ostensibly for receiving the computer services (Pet. App. A30). Shortly thereafter, Mullaney obtained nearly all of the Fund's brokerage business through August 1974. A successor firm continued to make the $6,000 monthly payments to petitioners and continued to receive virtually all of the Fund's brokerage business for the remainder of 1974 (Pet. App. A30 n.10).[2]

Based on its evaluation of the record, the Commission found that the payments to petitioner Research included compensation for directing the Fund's portfolio brokerage business to the brokerage firms. In making that finding, the Commission noted that petitioners, by receiving payments from the brokerage firms at the same time they directed the Fund's portfolio brokerage to those firms, had entered into a serious conflict of interest. Consistent with well-established legal principles applicable to fiduciaries, the Commission concluded that petitioners had the burden of rebutting the resulting inference that they obtained prohibited compensation. The Commission found that they failed to meet this burden in view of

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[2]Richard Driehaus collaborated with petitioner Stowers in developing the computer research service. Driehaus became associated with Mullaney as its research director immediately after that firm agreed to pay Research for use of the computer system. He also became research director of the firm that succeeded Mullaney in August 1974 (Pet. App. A29-A30 & n.10). In addition to serving as director of research, Driehaus was the representative who received the brokerage business that was directed to these firms by petitioners (*ibid.*).

undisputed evidence showing that the computer service: (a) was novel and untried; (b) was nonetheless sold at a high price; and (c) was sold only to brokerage firms that were given the Fund's portfolio business, despite efforts to sell it to others (Pet. App. A38-A40; see also Pet. App. A29-A30).

In light of their willful violations of Section 17(e)(1), the Commission entered an order censuring both petitioners. Although the Commission found that petitioners' actions had "the potential for serious abuse" (Pet. App. A42), it concluded that a censure order would adequately protect investors in the circumstances of this case (Pet. App. A41-A42). Censure is the mildest remedy available in a Commission administrative proceeding; it imposes no restrictions on a respondent's activities.

In affirming the Commission's decision, the court of appeals held that the Commission utilized the proper standard of proof—a preponderance of the evidence—and correctly allocated the burden of going forward. In addition, it quoted with approval (Pet. App. A16) the Commission's finding (Pet. App. A36) that petitioners' management of the Fund's investments and their concurrent receipt of compensation from the brokerage firms resulted in a substantial conflict of interest:

> No longer could [petitioner Stowers] look at Twentieth Century's brokerage problems with an eye single to Twentieth Century's interests. Now he had an interest of his own at stake. He could not compare the brokerage services that Mullaney [and its successor] offered with those offered by other firms in the wholly disinterested way that the statute contemplates.

ARGUMENT

The decision of the court of appeals is correct and does not conflict with any decision of this Court or any other court of appeals. Further review is therefore unwarranted.

1. The court of appeals correctly rejected petitioners' contention that the Commission should be required to prove violations of Section 17(e)(1) by "clear and convincing evidence," rather than a "preponderance of the evidence." With the exception of two recent decisions of the same court of appeals that decided the present case (see *Collins Securities Corp.* v. *SEC*, 562 F. 2d 820 (D.C. Cir. 1977), and *Whitney* v. *SEC*, 604 F. 2d 676 (D.C. Cir. 1979)), the courts of appeals consistently have held that administrative adjudications under the federal securities laws do not require a standard of proof greater than the preponderance standard.[3] In distinguishing its earlier decision in the *Collins* case, which held that clear and convincing evidence was required in the Commission administrative proceeding there involved, the court below pointed out (Pet. App. A13-A14 n.41) (emphasis in original):

> *Collins* required the higher standard in *fraud* actions where a *severe sanction* is imposed. Since neither one

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[3]In addition to the decision of the District of Columbia Circuit in the present case, see *Decker* v. *SEC*, [Current] Fed. Sec. L. Rep. (CCH) para. 97,614 at 98,298 (10th Cir. Aug. 18, 1980); *Steadman* v. *SEC*, 603 F. 2d 1126, 1139 (5th Cir. 1979), cert. granted, No. 79-1266 (April 28, 1980); *Abbett, Sommer & Co.* v. *SEC*, [1970-1971] Fed. Sec. L. Rep. (CCH) para. 92,813 (D.C. Cir. 1970), cert. denied, 401 U.S. 974 (1971); *DeMammos* v. *SEC*, 23 Ad. L.2d 221 (2d Cir.), aff'g 43 S.E.C. 333, 337 (1967); *Wright* v. *SEC*, 112 F. 2d 89, 94 (2d Cir. 1940).

In *Steadman*, which is pending before this Court, the Fifth Circuit held—in a case involving violations of antifraud provisions of the federal securities laws and a remedial order barring the respondent from serving as an investment adviser—that a preponderance of the evidence is the appropriate standard of proof.

of these elements is found in this case, *Collins* is inapplicable.

Not only is the sanction imposed here, censure, the mildest remedy the Commission can order, but Section 17(e)(1) is not an antifraud provision. It is a specialized provision designed to prevent investment advisers and other affiliates of investment companies from "having their judgment and fidelity impaired by conflicts of interest." *United States* v. *Deutsch*, 451 F. 2d 98, 109 (2d Cir. 1971), cert. denied, 404 U.S. 1019 (1972). It flatly prohibits an affiliate of an investment company, acting as agent, from receiving compensation (other than regular salary or wages) "for the purchase or sale of any property to or for" the investment company, whether or not fraud is involved.[4]

There is no merit to the assertion (Pet. 9) that the decision of the court of appeals conflicts with this Court's decision in *Addington* v. *Texas*, 441 U.S. 418 (1979). *Addington* establishes that selection of the appropriate standard of proof requires a balancing of the individual interest asserted by a litigant and the interest sought to be protected by the government. The Court concluded in

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[4]Accordingly, there is no need to hold the present petition pending the disposition of *Steadman* v. *SEC, supra*. Petitioner Steadman contends that clear and convincing evidence is required in a Commission adjudicatory proceeding involving allegations of "fraud" that leads to the imposition of an order barring a securities professional from participation in the investment advisory industry (Br. 8, 15, 24). Even if Steadman's contention were accepted by this Court, it would lend no support for the assertion in the present case, which would require clear and convincing evidence even in the absence of an allegation of fraud or an order resulting in a severe sanction. No court has ever suggested that violation of a statutory provision comparable to Section 17(e)(1) must be proven by clear and convincing evidence.

Addington that, because involuntary civil commitment involves a significant deprivation of liberty, due process requires clear and convincing evidence to justify confinement. There is no comparison between the significant deprivation of liberty involved in *Addington* and the censure that the Commission ordered in the present case. See *Vance* v. *Terrazas*, 444 U.S. 252, 266-267 (1980). Moreover, petitioners are fiduciaries and the instant proceeding seeks to protect their beneficiaries from harm that can result from conflicts of interest. The fiduciary principle requires that the interests of the beneficiaries come first and strongly supports use of the traditional preponderance of the evidence standard here. As the Tenth Circuit recently held in *Decker* v. *SEC, supra,* [Current] Fed. Sec. L. Rep. (CCH) para. 97,614 at 98,298, in reviewing the Commission's finding that a respondent in an administrative proceeding had aided and abetted violations of the same provision involved in the instant case: "We have weighed the competing interests * * * and concluude that the proper standard * * * is preponderance of the evidence."

2. Contrary to petitioners' assertion (Pet. 9-13) that the Commission relied upon "an irrebuttable inference" in finding that they had violated Section 17(e)(1), the Commission shifted the burden to petitioners only after examining evidence showing that they had placed themselves in a conflict of interest by receiving payments from the brokerage firms at the same time they directed the Fund's portfolio business to those firms.[5] Then, after

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[5]Once a fiduciary relation has been shown and apparent self-dealing has been proven, the burden shifts to the fiduciary to show that he has not abused the relationship. See, *e.g., Garrett* v. *Moore-McCormack Co.*, 317 U.S. 239, 247 (1942); *Geddes* v. *Anaconda Copper Mining Co.*, 254 U.S. 590, 599 (1921); *Ohio Drill & Tool Co.* v. *Johnson*, 498 F. 2d 186, 195 (6th Cir. 1974); *Sheridan* v. *Perpetual Building Ass'n*, 299 F. 2d 463, 465 (D.C. Cir. 1962).

considering the record, the Commission found that petitioners had failed to rebut the resulting inference that they had received prohibited compensation. As the court of appeals noted in upholding the Commission's finding (Pet. App. A13; footnotes omitted):

> [T]he Commission applied the long-standing principle that once a conflict of interest is proven, the burden shifts to the party in conflict to prove that he has been faithful to his trust. In the context of section 17(e)(1), the specific burden is for the affiliated person to prove that he has received no compensation "for the purchase or sale of any property to or for" the investment company. The Commission correctly found that petitioners were unable to do this.

The Commission found that the nexus between the payments to petitioner Research and the direction of virtually all of the Fund's portfolio business to the brokerage firms "was so close as to compel the inference that the payments were made for a single package * * * " that included the Fund's brokerage business (Pet. App. A39). In making that determination, the Commission noted that the computer system was "novel, untried, and expensive" (Pet. App. A38); that there was no market—and therefore no market price—for the system (*ibid.*); and that the record "does not show that anyone not interested in getting brokerage was willing to pay anything like $6,000 a month for Stowers's system" (*id.* at A40).[6]

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[6]The Commission noted that if petitioners had shown that some brokers who got no brokerage business from petitioners had paid $6,000 per month for Stowers's system, that "would shift the burden of going forward to [the Commission] staff." See Pet. App. A40 n.28.

Accordingly, the Commission's finding that the payments constituted prohibited compensation is supported by substantial evidence in the record.[7]

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[7]This case differs from *Decker* v. *SEC*, *supra*, where the Tenth Circuit recently reversed and remanded a decision of the Commission finding a violation of Section 17(e)(1). In that case, as in this one, the Commission determined that once a conflict of interest is established, the burden shifts to the affiliate of the investment company to show that it did not receive prohibited compensation, and that this burden can only be sustained by objective evidence such as evidence of the price actually paid in comparable sales to third parties. The court of appeals in *Decker*, although agreeing with the Commission as to the shifting of the burden, reversed because it concluded that the Commission had refused to consider relevant valuation evidence other than the price paid in comparable sales. In *Decker*, the investment company affiliate, although offering no evidence of such sales, did introduce expert testimony as to the value of the services provided. In the present case, in contrast, petitioners offered no such expert testimony and no evidence of comparable sales. Their evidence related rather to the reproduction cost of the computer system and the value of a computer service that was not comparable to the one sold here. Accordingly, even under the court of appeals' holding in *Decker*, petitioners have not satisfied their burden, and there is no conflict between the decision in *Decker* and the decision of the court of appeals here.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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